This record is a partial extract of the original cable. The full text of the original cable is not available.

081546Z Feb 05

C O N F I D E N T I A L SECTION 01 OF 03 TEGUCIGALPA 000284

SIPDIS

STATE FOR EB, WHA/EPSC, AND WHA/CEN
TREASURY FOR DDOUGLASS
STATE PASS AID FOR LAC/CAM

E.O. 12958: DECL: 02/08/2015
TAGS: ECON EINV PGOV HO
SUBJECT: HONDURAS: IMF GENERALLY PLEASED

Classified By: Economic Chief Patrick Dunn; reasons 1.4 (b) and (d).

¶1. (C) Summary: The IMF Article IV mission currently visiting Honduras is pleased with the GOH's significant progress on fiscal discipline, monetary policy reforms, and compliance with all but one quantitative target of the current Poverty Reduction and Growth Facility (PRGF). One non-quantitative performance criterion (new regulations for teachers' salaries) remains unmet, but the Fund recognizes that political difficulties preclude resolving this issue before the March Board Meeting. The Fund is seeking reassurance from the GOH that these reforms will be completed soon, and fully implemented on schedule by 2007, but otherwise feels it would be "disproportionate to make this a make-or-break issue." Concerning HIPC's eight Performance Criteria (PC), the team found that all appear to have been met (or will be during the Board's March meeting) with the exception of the last: "substantial compliance" with the Basel Core Principles. The Fund team intends to seek a waiver of this PC, given continuing progress towards compliance and the mitigating circumstance of a Hurricane Mitch-weakened banking sector that impeded prompt implementation. The Fund team will not, however, make a formal recommendation about Honduran eligibility for HIPC Completion Point at the conclusion of its mission this week. Instead, the team will await developments during and after the political primary elections on February 20 before finalizing its recommendation only just prior to delivering its report to the Board in late March. End Summary.

Strong Economic Performance

¶2. (C) On February 2, IMF Review Team leader Luis Breuer briefed the international donor community on the results of the Fund's Article IV review of Honduras, concluding this week. Breuer said the team had found a "very positive" macroeconomic scenario, with good growth (estimated at 4.6 percent in 2004) and a strong recovery in agriculture (which grew at an estimated 8.6 percent in 2004). The challenge of foreign reserves accumulation of over USD 500 million was handled well by GOH monetary authorities. Inflation, at over 9 percent, exceeded targets, due primarily to the rising cost of energy inputs. Breuer said the team was favorably impressed, nevertheless, that Honduras could grow at a strong 4.6 percent, given the high oil prices of 2004, and still keep inflation in the single digits.

¶3. (C) Asked for prospects for 2005, Breuer offered the following preliminary analyses. Growth in 2005 is expected to slow to 4.2 percent, due to fewer large projects, slowing growth in agriculture, and slowing growth in the U.S. economy, Honduras' largest trade partner. (Comment: This contrasts with recent comments by President Ricardo Maduro that growth in 2005 is expected to exceed 5 percent. End comment). Inflation is expected to return to under seven percent, assuming relatively stable energy input prices on the commodities (such as bunker fuel) that Honduras imports. The fiscal deficit is expected to fall by one-half percent of GDP, to 3 percent, thanks to flat expenditures and a growing economy. Remittances are predicted to slow their rate of increase from this year's estimated 30 percent to a still robust 18 percent in 2005. Monetary policies to handle such large forex inflows will remain a challenge, though current actions to reform liquidity controls should help. The current account deficit should fall to 2.6 percent of GDP as capital imports for large projects decline. However, offsetting this somewhat, continuing growth in remittances and a booming domestic economy will likely contribute to an increase in imports of consumer goods.

Team's Conclusions Largely Positive

¶4. (C) The team examined progress on the Fund's own Poverty Reduction and Growth Facility (PRGF), as well as the question of whether the GOH has met the eight heavily Indebted Poor Countries (HIPC) Performance Criteria (PC). The two reviews -- and programs -- are distinct but interrelated. For

example, a successful PRGF review is one of the eight PCs under HIPC, as is Board approval of the Joint Staff Assessment following this annual review.

¶5. (C) The team has preliminarily concluded that the GOH has met all PRGF quantitative criteria, with one minor exception. There was apparently slight overspending (approximately USD 50,000) on wages. The team noted that this does not constitute a breaking of the wage ceiling. The unbudgeted spending resulted from restructuring the Supreme Court of Accounts (TSC) as part of the GOH anti-corruption strategy, and the team considered this a "prudent fiscal policy." The GOH wage bill grew in absolute terms by 8.8 percent in 2004, or less than the rate of inflation. Thus, when combined with GDP growth, the percentage of national income devoted to wages fell in 2004.

¶6. (C) The Poverty Reduction and Growth Facility (PRGF) Performance Criterion on teachers' wages -- requiring the issuance of regulations by December 2004 with compliance by 2007 -- was not met, but there is no fiscal consequence of this for 2005, since no action is required until 2007. Per a 2003 salary law and a 2004 agreement with teachers, the wage-related benefits for teachers (such as additional payments for seniority) should be folded in to their wage scale by 2007. In recent years, growth in teachers' salaries has exploded, rising much faster than inflation and rising from six percent of GDP to eleven percent in just a few years. One unsustainable consequence is that an estimated 96 percent of the entire Ministry of Education budget is spent on teachers' wages, leaving just 2 percent for the national university (UNAH) and 2 percent for everything else, including books and facilities.

¶7. (C) The Fund is seeking a waiver of this PC, but only because: they see the 2005 program in Honduras as "fully financed"; they recognize the extreme political difficulty in passing such regulations in an election year; and they recognize the significant progress the GOH has made on more pressing fiscal and monetary reforms. That said, the Fund must have a "clear agreement" with the GOH that the regulations will be implemented. If the GOH cannot build its credibility with the international community before HIPC Completion Point is reached, the Team asked rhetorically, how would it be able to do so after? In the final analysis though, Fund Central America Director Adrienne Cheasty told the group, that it would be "disproportionate to make this a make-or-break issue."

¶8. (C) On HIPC's eight triggers in moving towards Completion Point, the team found that all appear to have been met (or will be during the Board's March meeting) with the exception of the last: "substantial compliance" with the Basel Core Principles. The Fund team intends to seek a waiver of this PC. In the team's view, there has been "impressive progress" but not "substantial compliance," if one defines that ("poorly written") performance measure as meeting half of the principles. Of course, the team noted, about half of all Latin American countries fail to meet that standard, so Honduras should not be judged too harshly. Additionally, it took the GOH time to determine the solvency of many banks in the post-Hurricane Mitch environment. Over time it was discovered that many were weaker than at first thought, and therefore a quick, rigorous application of the Core Principles could have led to the collapse of a large portion of the banking system. In view of the circumstances, a more gradual approach was called for.

¶9. (C) The Fund team will not make a formal recommendation about Honduran eligibility for HIPC Completion Point at the conclusion of this mission this week. Instead, they will only highlight the substantial progress the GOH has made and await developments during and after the political primary elections on February 20. Taking into account any developments during the month of March, the team will finalize its recommendation only just prior to delivering its report to the Board in late March.

International Community Counsels Leniency

¶10. (C) Responding to the Fund's presentation, Germany noted that the teachers' wages issue could not be solved before the March Board meeting, so how the issue is presented to the Board will be critical. The international community in Honduras, meanwhile, should play its role in talking to the crop of presidential candidates about transition issues and the need to keep faith with the Fund. However, it will be difficult to get the candidates to be "reasonable" during a campaign. Japan echoed these comments, noting that the team should avoid putting the wrong conditionalities before the Board. Moreover, even if HIPC Completion Point is reached, the international community retains some leverage through ongoing programs to press this issue in the coming months.

¶11. (C) Spain noted that the GOH macroeconomic performance

has been "outstanding" and argued strongly that imposing additional conditionalities after the GOH has taken so many difficult economic reform measures would be "unfair." The GOH should not be "punished" for falling short on this one, non-critical PC, but instead should be "given the benefit of a doubt." Several other donors agreed with this view. The Interamerican Development Bank noted that the GOH had made great strides, particularly in fiscal discipline, and that any delay in HIPC Completion Point would "send the wrong signal." The international community should instead focus on supporting the GOH through its coming electoral transition, with a view towards making the recently enacted reforms sustainable over the long-term.

¶12. (C) The European Commission noted that the issue of teachers' salaries was not currently a feature of the political debate and should stay that way. To raise the profile of the issue would politicize it, and then getting "reasonableness" from the various parties to the dispute will become impossible. The Fund replied that all should refrain from making teachers' salaries "too much of an issue" since the needed reforms "are already the law." Even though the GOH missed this PC, "the program remains intact."

¶13. (C) Sweden asked why, if the GOH is doing so well, the poor do not seem to be benefiting. Breuer pointed out that the Fund is examining the impact on the poor in its evaluation of the Poverty Reduction Strategy Program (PRSP). While Honduras has shown positive but limited progress (e.g. 18 percent movement toward completion of the Millennium Development Goals, 0.8 percent increase in per capita income in 2004), in general progress towards social targets is slow. Furthermore, a majority of the financing made available under HIPC interim debt relief has been budgeted by the GOH for social services rather than economic growth and, therefore, does not directly impact per capita incomes. The World Bank agreed, noting that the GOH long-term strategy of poverty reduction is targeted through 2015, and is unlikely to show dramatic progress in any one year. The real question is whether the GOH appears sufficiently committed to these long-term goals, "and the answer appears to be yes."

¶14. (C) Next steps: The Fund will now generate its Second Report on the PRGF, its Recommendations concerning HIPC Completion Point, its Progress Report, and a Joint Staff Assessment. These reports will be presented to the Board two weeks before the Board meeting, likely to take place in late March. The team is also currently negotiating terms for 2005, the second year of the Fund's three-year PRGF program in Honduras. Foci will include improving tax collection, continuing strong reforms of the financial sector (led by "an ambitious program by the National Banking and Insurance Commission"), and continued wage restraint. The medium-term redesign of teachers' wages will remain a key challenge.
Palmer